

Debt Sustainability Revisited

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The present course of assessing debt sustainability – toward further econometric sophistication – risks being more harmful than helpful. To develop support for this claim, this paper first recounts what economic theory says about sovereign debt, and then continues by analysing the methodology and approach that the assessment of debt sustainability rests on today. Building on these accounts, this paper argues that debt sustainability should be lifted away from the narrow econometric seat where it is now found and, instead, should be placed in between problem debt on the one side and economic and social human rights on the other. The paper concludes by proposing an orderly framework promoting equal rights of debtor and creditor nations in debt negotiations. Importantly, it is up to the indebted nation to decide on the sustainability of its sovereign debt, not the creditors.

Some, usually defenders of unfettered capitalism, are convinced that high levels of indebtedness in a country is a consequence of poor economic policy where a nation has lived beyond its means and therefore, the government must decrease its expenditure and raise its income (see Euronews 2011; Blanchard & Leigh 2013; Torry 2013). Accordingly, it is up to the creditors to decide whether they grant financial rescue packages to the indebted country or not, and under what conditions. Others agree in seeing mounting debt as a consequence of economic policy, but their view is global, not national (see Krugman & Layard 2010; Raffer 2010; Stiglitz 2010b; see also Palley 2003; UNCTAD 2009b for complementary arguments). This Keynesian view sees one nation's current account deficit as another's surplus and therefore, regards overindebtedness to be a common global concern. Importantly, the austerity measures proposed by those supporting unfettered capitalism stand in contrast to the prescriptions of the Keynesians, who argue for shifting the focus away from debt levels and toward promoting full employment by means of increasing domestic spending and investments.

Between these views, one of the questions that arises forcefully is how to decide on the sustainability of sovereign debt. Attempts at pin-pointing thresholds for sustainable debt levels are often linked to low-income countries and always

José Filipe Silva & Alejandro Lorite Escorihuela (eds) 2013
Dictatorship of Failure: The Discourse of Democratic Failure in the Current European Crisis

COLLEGIUM

Studies across Disciplines in the Humanities and Social Sciences 14.
Helsinki: Helsinki Collegium for Advanced Studies. 122–142.

econometrically estimated (Caner, Grennes & Koehler-Geib 2011, 73; Cecchetti, Mohanty & Zampolli 2011; Manasse, Roubini & Schimmelpfennig 2003; Reinhart & Rogoff 2010, see also Addison, Hansen & Tarp 2004). These efforts are contested for not taking into account the historical developments or circumstances of the debt build-up, for ignoring the specific characteristics of sovereign debt versus other forms of debt, and for not distinguishing between different components of sovereign debt (Herndon, Ash, Pollin 2013; Nersisyan & Wray 2010). It is possible that identifying a universal threshold or ratio of debt without arbitrariness is not even feasible. If so, a continued focus on macroeconomic sophistication and technical detail will not make the assessments more accurate, but rather, risks blurring the broad purpose of dealing with problem debt (see Wyplosz 2009). What we need is a shift in focus, approach and methodology. It is not only about determining when debts become unsustainable, but also how this is decided upon, by whom and through what process.

The general point of this article is that establishing thresholds of sovereign debt, even if they were feasible, may in fact be more harmful than helpful. This is because the welfare of a country's citizens must not be sacrificed in the name of unpredictable or speculative sovereign-debt markets or inadequate or short-term fiscal calculations as a reaction to such thresholds (see Stein & Weeks 2012). Instead, the purpose must be to promote the economically sustainable well-being of the population in both creditor and debtor nations by dealing with problem debt not only in an orderly way but also in a swift, sustainable and just manner. The carrying argument of this article is that debt sustainability is a *political* matter that must be assessed by the indebted nation and this assessment cannot be based on econometric parameters alone. This is due to the peculiar characteristics of sovereign debt where a nation's resources are infinite because of its right to levy taxes. In support of this argument, there are two additional and particular qualifications to keep in mind; debt sustainability must be placed in its proper frames of politics and justice where it belongs.

First, popular uprisings in indebted nations in response to budget cuts and social hardship should be given the appropriate attention for the political crises that they are. This relates to the protection of human rights – and social and economic rights in particular – in the indebted country, with reference to the Charter of the United Nations where governments are obliged to provide a minimal standard of living for their people. Such uprisings can be seen as a reaction to the strain between the two sets of principles behind the global institutional order: the global financial structure was established at Bretton Woods in 1944 and four years later the UN adopted the Universal Declaration of Human Rights. These two institutional, parallel paradigms form a tension between protecting the advantageous positions of rich nations on the one hand and securing equal rights for every individual on the other. Second, the justice dimension that promotes the role of the indebted nation in debt negotiations requires further attention. This is because so far, the

determination of sustainable debt levels is in the hands of creditors with an interest in getting their investments repaid, and the debtors have little say.

This article does not seek to contribute to the theoretical discussions on sovereign debt, nor at adding to the literature analyzing the technicalities or empirical research of debt sustainability measures or contrasting them to each other. Instead, this article hopes to contribute to the discussions on global governance and the overall thinking on the *principles* behind the tolerance levels of sovereign debt. This contribution provides a complement to the body of literature promoting the idea of putting in place an orderly mechanism for dealing with problem debt (see Helleiner 2008; Herman, Ocampo & Spiegel 2010a; Palley 2003; Raffer 1990; Schwarcz 2000; Smith 1776/2009; Soederberg 2005 and Stiglitz 2002a among others). While the suggested principles of the mechanism that these proposals rest on vary within a fairly wide range, they unite in calling for a mechanism to deal with unsustainable debt burdens. Yet, the proposals leave open the definition of debt sustainability.

This article is divided into four parts. This first section reviews the literature on the theoretical considerations regarding the dynamics and peculiarities of sovereign debt. In dealing properly with sovereign debt, we must understand its particularities. Comparisons between sovereign debt and other forms of debt must be made with caution. This includes clearly and consistently separating our thinking along the lines of private, individual or corporate debt on the one hand and sovereign debt on the other. In the second section the focus shifts to an analysis of where we stand in the empirical field of assessing debt sustainability, including the methodology behind the current econometrically-derived debt sustainability assessments and suggested universal debt thresholds. The third section explains the political and ideological process behind contemporary dealings with debt and argues for an orderly framework for nations to declare that their debt is unsustainable as an alternative. Since a country can never go bankrupt in the same sense as a corporation, the sustainability of sovereign debt is a political issue that cannot be limited to economic factors alone. The fourth section concludes that a politically unsustainable debt burden is unsustainable also from an economic point of view, and to fulfil the justice dimension of problem debt, the unsustainability of debts must be declared by the indebted nation, not its creditors.

I. Separating sovereign debt from other forms of debt

Dealing with crises of sovereign debt in the post-World War period resembles an opt-in system. This has led to incremental processes and negotiations, both unofficial and official. Importantly, the *ad hoc* way of meeting debt crises has in effect led to a slow process of institutionalization: debt crises are systematically met with austerity requirements by the creditors toward the debtors. There are three justifications for this. One, the requirements for austerity policies became dominant in the 1980s following the general shift in economic thinking from Keynesianism

towards unregulated capitalism. The new thinking supported the interpretation that the reason behind debt build-up is over-spending and, therefore, the prescription was belt-tightening. Two, belt-tightening policies echo the preferences and logic of credit-rating agencies. Investors react to assumed ratios of debt sustainability and, consequently, demand fiscal austerity programmes to cut government spending. This is because they react to debt-to-gross domestic product ratios and thus demand immediate improvements in these conditions. Three, in the official discourse, where public debt is often compared to private debt, belt-tightening policies are dominant. This analogy has re-emerged with the Euro crisis, where the media, politicians and observers often assume sovereign debt to have the same characteristics as personal or corporate debts. The conclusion from this assumption is then that just like a personal credit card debt, a mortgage or a corporate loan, this debt must eventually be paid off and the way to go about this is to agree on a plan that will allow the borrower to pay off his, her or its debt.

Consequently, when a government declares its inability to meet its payments obligations on time, this results in a plan for how to cut spending, according to any of the lines of thinking above. The plan is always swift in implementation and often drastic in measure. The immediate aim of decreasing debt levels becomes the main focus. To cast doubt on these uniform and seemingly automatic requirements for austerity policies, it is essential to separate out the particular characteristics of sovereign debt. Sovereign debt is not well understood, and it is often surrounded by misconceptions.

To begin with, it is fundamental to sort out the meaning of open and closed systems. The general principles on which a business and a national economy must be run are different (Krugman 2009, 27, 30). Business people, for instance, are not used to thinking about closed systems; economists are (Krugman 2009, 33). This means two things. First, in theory and from a business perspective, an open system implies that a(ny) corporation could well realise its goal of doubling its market share in say, two years. At the same time, the economist realises the impossibility of *every* company actually doubling its market share in the same two-year period – whether nationally or globally. Globally, countries with exports exceeding their imports create a surplus versus those countries that import more than they export. Global trade balances always equal zero, which means that someone's surplus is always someone else's deficit. But it is also not unproblematic to be a big surplus nation, as this would mean that the demand in its export markets is suppressed. This was the carrying thought of John Maynard Keynes (1943), who thought that it is in the global interest to tax not only deficit but also surplus nations.

But sovereign debt must not be approached solely from the point of view of economic theory. The second meaning of economists operating on the assumption of closed systems is methodological and concerns the very foundations of economics. Their preferred method is econometrics, and with this comes a search for, or at least an assumption of, closed systems. But for a system to be closed, it has to fulfil both the intrinsic and extrinsic condition (Sayer 1984, 121–25). The

intrinsic condition says that if mechanisms are to operate consistently, there can be no change in the object that possesses the causal powers. Other things being equal, problem debt will not produce regular effects if the internal composition of the debt changes. The extrinsic condition for closure says that for the outcome to be regular, the relationship between the causal mechanism and those of its external conditions, which may make a difference to its operation and effects, must be constant. If the political sympathies of the population of the country struggling with problem debt change for reasons independent of the debt burden, the effect of debt sustainability assessments cannot be said to be manifested as a regularity.

Further, sovereign debt is made up of various kinds of debt; private, public, external or internal. There is a fairly fundamental difference between domestic and external debt, or fiscal versus external sustainability. These debts build up as a result of different and separate mechanisms and, as a consequence, there are no quick-fix budgetary transfers available to solve any one problem. The ability to generate international currency to pay interest and principal is not directly related to a country's ability to grow or to broaden its tax base (see UNCTAD 2009b, 20–24, also for the latter part of this paragraph). This is because international currency is generated through exports whereas taxation is levied on labour and domestically produced goods and services. For instance, the US trade deficit is a result of an imbalance in its current account; the US has imported more than it has exported. This is also why Keynes (1929) criticized the idea that a large external debt is mainly a budgetary problem. Fiscal sustainability provides another example of how a concept suffers from inexact definitions.¹ Usually, it stands for the stabilizing of a particular debt-to-GDP ratio but does not say anything about the optimality of this ratio. Also, the indicator does not establish the conditions necessary for long-run sustainability, and thus does not provide space for counter-cyclical policies, such as a government increasing its national spending in hard economic times. To complicate matters further, there are no good definitions of external or domestic debt. Confusing determinants are the country of residence of the creditor and the place of issue, and legislation that regulates the debt contract.

In dealing with these different forms of debt, attempts at bridging the gaps with the help of loans do not address mend the *cause* of the deficits. Also, debt balancing must be done with caution; a sudden swing from deficit to surplus in the current accounts of a nation, if the deficit originates from a capital flow reversal, may have serious economic costs in the form of inflation, or Dutch disease.² This means that a government seeking to balance its books must not make cutting the deficit its only focus.

1 For instance, see Ghosh, Kim, Mendoza, Ostry & Qureshi (2011) for an attempt at answering the question of how high public debt can rise without compromising fiscal solvency.

2 Dutch disease stands for a situation when a country receives a large inflow of foreign currency, for instance in the form of aid, as disaster aid relief, or from natural resources (oil is an often mentioned favourite in this context). Eventually, this leads to a rise in the exchange rate, which makes domestic production less competitive internationally and risks leading the nations affected into economic difficulties.

Belt-tightening in the household comes without the structural effects of belt-tightening by the government. Actually, deficit reduction in response to situations of high sovereign debt brings with it a real danger. When a government raises taxes and cuts benefits in response to high levels of debt, not only are the vulnerable in society affected, but job opportunities decrease and, in the long run, the effects of the cuts are long lasting. If the focus is blindly fixed on cutting deficits, the long-term goal of supporting an educated and healthy population is suppressed and so are the chances of future economic growth. The point here is the relation between long-term debt and investments in education, technology, health care, social benefits and infrastructure: sectors where investments in the long-term could lead to lowered deficits. Instead of focusing on the deficit and on what the country owes, one must also look at its assets (Stiglitz 2010b). The reliance on Gross Domestic Product, GDP, as an indicator of national wealth comes with a set of warnings, as we shall see. For now, the point is that particular budget outcomes should never be a policy target. What the government should be targeting is real goals, such as a sustainable growth rate buoyed by full employment (Gee 2011). As a consequence of these targets, a weaker economy calls for a larger deficit and the appropriate size of the deficit in the face of a recession depends on the precise circumstances (Stiglitz 2010b).

Austerity policies thus shrink the GDPs of their nations. With a lower GDP, the debt-to-GDP ratio is bound to grow. Those promoting austerity see this as a temporary and necessary phase. But the history of austerity is not encouraging: it failed in Latin America, Africa, East Asia and will fail in Europe (Stiglitz 2011). The austerity policies applied in the Euro nations suffering from debt problems have resulted in high unemployment levels approaching 27 per cent in Greece and 26 per cent in Spain (EUROSTAT 2013). From that perspective, the focus on stricter budgetary discipline is not enough to cure Europe's problems. A few years ago, for instance, Germany's budget deficit was higher than Spain's, but the competitiveness of the German economy far outpaced that of its southern neighbours (Alderman 2012). This is why hundreds of economists have forcefully expressed in open letters to policy makers their concern at how the European debt crisis is being dealt with (Krugman & Layard 2012; Sinn 2012). This traditional default position of the International Monetary Fund, to require austerity measures for overindebted nations, has arrived at a crossroads with the Euro crisis, since empirical research shows that the IMF may have based its forecasts on fiscal multipliers that were too high (Blanchard & Leigh 2013).

Unlike individuals or corporations, governments do not have to repay their debts. In fact, they rarely run down their overall stock of debt, and the history of sovereign defaults is neither short nor unimportant (Gee 2011; see also Reinhart & Rogoff 2009 for a catalogue of such defaults). This is because a government has its own central bank and currency and if need be, it can always print more of its own currency. This helps explain why the US can sustain such high and increasing levels of debt; other countries also borrow in US dollars, but they do not have

the added advantage of printing the currency. Given this, the US may be more vulnerable to the risk of prolonged economic stagnation than to a sudden crisis – thus following in Japan's footsteps (Sahadi 2012). The inflation risk associated with printing money is generally seen as a drawback because of the higher interest rates this may bring with it and the consequences this has on society. But this has to be balanced against the advantage of actually melting the debt at the rate of the inflation. Yet, the initiative of printing money does not hold automatically for the Euro zone, at least not in the way the currency union is now organised. In the Euro zone, by creating an independent central bank, the member countries have become indebted in a currency that they do not control.

Because of its right to tax, in theory, a nation has indefinite resources on which to draw. This is also why the sustainability (or illiquidity versus solvency) of sovereign debt is less easy to calculate than for instance the solvency of an individual or a corporation. In basic economics, a debt is solvent when the future surplus is large enough to repay the debt, principal and interest. In practice, however, deep social unrest in response to austerity measures is an indicator of the population's (in) tolerance of the level of debt.

Sovereign debt also differs from private debt in that the resources of a nation cannot be liquidated as in, for instance, the case of the bankruptcy of a firm. To illustrate, a loan made to a country for it to improve its infrastructure may leave behind roads, bridges and buildings which are impossible to transport abroad and thus troublesome to claim by the creditors.

Finally, market-oriented societies have laws and insolvency proceedings for corporations and individuals. But if a country has high levels of problem debt, there is no instance that would have the legitimacy or the expertise to oversee an international, orderly, fair and speedy process of dealing with global debt. This role has largely been played by the IMF. But the IMF is itself a creditor, which means that it is neither an objective nor an impartial institution for dealing with these matters. In practice though the narrative is usually more acute than analytical. Often, sudden financial or banking crises are followed by debt and economic crises. This means that what has turned into a debt crisis may still be treated as a (temporary) financial crisis of liquid cash. The call to the IMF is about *ad hoc* and immediate financial support. Often, there is little space and not enough time for a thorough assessment of the situation. In response to reactions in the markets, quick reductions of deficits and debts are undertaken. Such austerity policies tend to create social unrest, as seen most recently in Southern Europe, and, ultimately, the financial crisis turns into a political crisis.

Within these cornerstones of the theory of sovereign debt, there are major differences about the perceived accurateness of theories and, consequently, about the appropriate economic models. Given this, there will always be disagreements about the assessments, their priorities and emphases (as reminded by Stiglitz 2010a, 62). This is also why this review has focussed on the dynamics, the settings and the qualifications of sovereign debt, rather than policy prescriptions of individual

cases. With this in mind, the next section looks into the lessons learned from the empirical work on debt sustainability.

II. Considerations regarding assessments of debt sustainability

Debt sustainability is a young concept and the assessments are part of a process which is itself in development. To date, the empirical observations are primarily limited to low-income countries in Latin America and Africa.³ Debt sustainability assessments form the very core of debt relief programmes and it is also in this context that the analyses to date have been framed.⁴ There are six particular concerns that can be separated out from these systematised practices. One, the fairly wide range of different meanings of debt sustainability confuses its application and complicates further work. Two, the methodology and specific variables merit further analysis. Three, debt sustainability assessments are, to varying degrees, based on GDP, a crude concept itself. Four, traditionally, situations of problem debt are not separated into situations of insolvency and temporary states of illiquidity, but all situations are treated in similar fashion and with a state of urgency. Five, debt sustainability is always assessed by the creditors, and the indebted nation has little say in the process. Six, the attempt to assess debt sustainability according to universal criteria carries risks. Among other issues, the assessments leave out historic developments behind the building of debt while ignoring the dynamics related to debt sustainability. This is also the order in which the groups are discussed.

Underneath the general definition of debt sustainability that stands for when a country's debt becomes too big for it to be serviced, a number of more specific definitions compete.⁵ Some relate debt sustainability to national budgetary problems while others relate it to transfer problems (Addison *et al.* 2004, 8; UNCTAD 2009b, 20). Alternatively, it may or may not include the effect debt-servicing bears on economic growth or poverty alleviation (see Addison *et al.* 2004, 8–11). Or debt sustainability may focus on a country's willingness or capacity to serve its debt. These definitions leave to the side a broader set of issues related to the country's overall economic performance. For instance, a country can service its

3 For helpful compilations of articles, see UNCTAD (2009a; 2009b).

4 The frames are the Heavily Indebted Poor Countries-programmes, HIPC (1996–), the Debt Sustainability Analysis, DSA (2002–) and the Multilateral Debt Relief Initiative, MDRI (2005–).

5 This can be categorized into six key concepts of varying definitions of debt sustainability: A. Threshold level of debt/GDP, ratio; B. Solvency, or the condition that future surpluses on current account are sufficient to cover interest obligations and repayments of principal; C. Debt serviceability, or solvency plus the additional condition of no illiquidity, which denotes an inability to service debts at particular moments in time; D. Solvency plus avoidance of the need for a major correction in the form of large cuts in public expenditure or large increases in taxation required for debt service; E. Networth, or the condition that the present value of current account surpluses less current debt is not decreasing over time; and finally F. Debt stationarity, or the condition that the debt/GDP ratio does not increase beyond certain limits. (Cornford 2009, 3; Wyplosz 2009, 21.)

debt according to plan, but simultaneously, the basis of debt sustainability effects the eligibility of aid. If so, in the long run, debt relief risks leading to accumulated debts all over again. A fourth meaning takes on board aspects related to growth (for literature reviews see IMF 2012b, 121–128; Reinhart, Reinhart & Rogoff 2012). Because of the variation in the application of the term, its definition becomes both vague and general in a way that jeopardises its usefulness.

Further, the methodology of assessing debt sustainability requires attention. To begin with, the twin conditions for closed systems from the previous section calls into question the dominant focus on empirical methodology when assessing debt sustainability, a methodology assuming closed systems. For example, regarding the Heavily Indebted Poor Countries (HIPC) initiative and the sustainability issue in particular, the methodology is static and based on historical data in that it does not include provision for shocks or drastic changes in the country's economic environment, such as falling terms-of-trade (Addison *et al.* 2004, 11). What is more, inflation is often ignored in debt sustainability analyses (Wyplosz 2009, 8). Traditionally, debt sustainability exercises for low-income countries have concentrated on external debt. This dates back to the early 1990s when most external debt of poor countries was public and most public debt of low-income countries was external (UNCTAD 2009b, 20). But importantly the composition of sovereign debt has changed since then: private external debt and domestic public debt have become increasingly important, if not major, forms of debt. However defined, debt sustainability includes a large number of uncertainties; it is about probabilities rather than certainty (Wyplosz 2009). Essentially, the assessments are only valid within the bounds of the underlying guesses. The IMF's Debt Sustainability Assessment, for instance, has drawn macroeconomic policy making to a cross-roads where there is little support for the idea that added complexity allows for more precise assessments. It is a partial guide that should not be interpreted in too rigid or mechanical fashion (as underlined by the IMF (2012a) itself). Yet, because of its large degree of uncertainty, Wyplosz (2009) concludes that the DSA procedure is impossible: the process is too arbitrary and imprecise to serve as a tool for policy prescription.

In practice, the sustainability of sovereign debt is assessed either on how well debt can be serviced out of export earnings, or on how debt relates to GDP. This is important to take note of for three reasons. One, the debt-to-export ratios are problematic because a large export sector is not enough to generate the needed resources if import growth outpaces export growth (UNCTAD 2009b, 20). Two, neither are debt-to-GDP or debt-to-revenues ratios adequate measures of a country's ability to repay its external debt (recalling that external debt builds as a result of a need for foreign currency to pay for imports if they exceed exports) (UNCTAD 2009b, 20). Three, GDP itself is still an unrefined concept, and this of course relates to debt sustainability assessments based on GDP. To exemplify, because GDP reflects an average, the segmentation of society is left unnoticed: as the investment bankers of society get rich, they augment average income thus

leaving the decrease in income by potentially large segments of the population unnoticed. Today's sustainability assessments stand for the depletion of national resources and the degradation of the environment, where the processes should instead be arguing for guidance for creating a broader set of indicators that more accurately capture both the economic well-being and sustainability of nations' and ultimately, the earth's, resources (Stiglitz, Sen & Fitoussi 2010). Ultimately, it is not possible to reduce everything to a single number, GDP (Stiglitz *et al.* 2010). Moreover, natural assets are often hard to price well or at all. The Inclusive Wealth Report 2012 provides an attempt at assessing changes in a country's productive base, including produced, human, and natural capital over time (UNU 2012). The reason behind this initiative is that a fixation on short-term economic growth ignores, for instance, the destruction of natural resources and affects not only the country and its population but in the long run also humanity on a global scale. Looking toward the future, the constructive approach is that the 70-year-old GDP is still a crude estimate. The same applies to the far younger concept of debt sustainability. As for debt sustainability, the direct importance of GDP lies in the equations where debt sustainability is measured as a function of GDP.

As for deciding between solvency and illiquidity, the diagnosis of whether a country is insolvent is complex, yet when dealing with sovereign debt, one of the main considerations is that by treating a situation of insolvency as a temporary crisis of liquidity means that the risk of a crisis expands in the process. Wyplosz (2009, 18) sees sustainability as a function of solvency and sees that both concepts are faced with implementation difficulties. For one, sustainability is completely forward-looking and, yet, the input consists of historic data. Recalling that most governments are eternally indebted, matters are complicated further. Roubini (2001) sees that balancing between illiquidity and solvency places a government between two unrealistic choices, namely, low spending now and higher spending in the future – or vice versa. The effects of this situation are not softened by the consequences of quick reactions by credit-rating agencies to particular arbitrary ratios and their demands for fiscal austerity programmes – often immediately, radically and unconditionally. Consequently, households get scared and cut their expenditures, and business is dissuaded from borrowing to invest (see Shiller 2012). Current practice in dealing with debt is incomplete in the way it does not allow for a separation between the insolvency and illiquidity of sovereign debt.

Debt sustainability is a concept that drives the interest of lenders, steered by the question of 'when is a debt too big to be repaid', as in lenders losing their money. The principles behind debt sustainability date back to the debt crises of Latin America and Africa, and they have today been transported to Europe. In Latin America and Africa, debt sustainability constitutes the core of the eligibility criteria in applying for debt relief programmes of the development aid budgets of donor countries. In Europe, debt sustainability assessments are entrusted into the hands of the troika of the European Central Bank, the IMF and the EU Commission.

It may be impossible to come up with a methodology for assessing debt sustainability that is transferrable between countries. There are four particular reasons for this. One, the composition of debt differs, and, as seen, the dynamics of and between these differ. The situation of problem debt in Latin America in the 1980s was mainly a crisis of commercial debt but in the 1990s it was public debt that caused problems in Africa. Today, a main part of Japan's debt is domestic whereas the USA is indebted abroad.

Two, countries that issue their own currency (the United Kingdom, the USA, Japan) have different ways of dealing with debt than countries that do not (such as members of the Euro zone). A related point is that the effects of debt differ depending on whether a country's exchange rate is floating (USD, GBP, yen) or fixed (within the Euro zone countries are unable to devalue their currency). Attempts at pinpointing at what debt levels economic growth slows down have identified these at between 64–90 per cent of government debt-to-GDP, depending on the income levels of the countries (see Caner *et al.* 2011, 73; Manasse *et al.* 2003; Reinhart & Rogoff 2010). Building on the critical reactions to these, as raised earlier, the importance is here to highlight why the sovereign debt of different nations may not fit into an econometric closed-model scheme.

Three, according to public opinion, debt intolerance in other countries is due to poor policies, institutions or governance. UNCTAD (2009b, 3) rejects this conventional wisdom and argues that the key determinants of debt intolerance are the economic and debt structure of low-income countries.⁶ This relates both to the composition of trade, and it also underlines the dependency relations between the creditors and donors vis-à-vis the indebted nation.

Four, the process of financialisation has accelerated fast and today it constitutes a major factor, radically different more sophisticated and complex from what it was in the 1980s. With the 1940s and the creation of our global financial order as a backdrop, as mentioned earlier, today's economies use finance as the overwhelming capital mover, in contrast to trade, meaning that the balance of payments of countries are now different and have to be treated differently. Yet, the practical aspect of debt relief as a consequence of debt sustainability is focused on the current accounts of poor countries (Sachs 1995; Stiglitz 2010c).

Ideas about assessing and dealing with unsustainable debt in an orderly way and according to universal criteria are clearly needed. The initiatives must be separate from strategies for dealing with immediate crises, and the focus must be wider than that allowed by empirical methodology.

⁶ Debt intolerance stands for the phenomena when low-income countries suffer debt crisis at relatively low debt levels if compared to the standard of advanced economies (UNCTAD 2009b, 3).

III. Alternatives ways of thinking and doing debt sustainability

The standardized prescription of austerity policy as a means to correct the debt imbalances of a nation is not justified in the literature (see Blanchard & Leigh 2013; Herndon *et al.* 2013 for evidence casting doubt on these policy prescriptions). In addition, traditional debt sustainability assessments focus on mechanical, technical and empirical aspects. The experience of the post-World War II period in dealing with sovereign debt can be summed up in a few observations. The measurement of debt sustainability does not appropriately address the effects problem debt has on economic growth. Nor does it address its effects on human development, as for instance on poverty reduction, or, as we have seen in Europe, on the poverty that problem debt causes. Rather, as a rule, repayment of debt is prioritized over human rights and human dignity (see Council of Europe 2013 for how this takes place in Europe).⁷ The complexity of different types of debt is a warning for the analysis of external sustainability, in particular for drawing an analogy between it and calculations of sovereign debt (UNCTAD 2009b, 22). Further, it is worth repeating the importance of distinguishing between a temporary shock and endemic policy indiscipline as the root causes of problem debt (Wyplosz 2009, 21). If this is not done properly, it could mean that the roles of the composition of trade and current account imbalances are overlooked, as discussed earlier. Also, policy responses are *ad hoc* and reactive to a sudden crisis of sovereign debt. Finally, in Europe, debt relief packages and rescue loans have not only continued earlier established traditions, they have also reverted to the vocabulary of conditionality, abandoned over a decade ago in the low-income world.⁸ This use of conditionality is out of tune with the principles of democratic will promoted elsewhere, and among populations in indebted nations. Thus, the current methodological underpinnings leave out dynamic, long-term and historic factors, along with the international surroundings and context each nation faces in its own way.

On the other hand, debt sustainability assessments include the possibility of a debt being labeled as unsustainable. The question then becomes how to deal with this debt. Given that problem debt appears and reappears if not regularly, at least with a degree of certainty, the task at hand is to develop some kind of orderly and just mechanism for dealing with debt. This normative task is best approached

7 In addition to the Declaration of Human Rights articulating basic rights, subsequent documents of relevance are the International Covenant on Economic, Social and Cultural Rights (ICESCR) of 1966 stipulating that states have the right and the duty to articulate national development policies to implement the fundamental rights and the texts of the UN indicating that every country has the sovereign right to freely dispose of its natural resources for its development. Of course, the full International Bill of Human Rights, adding the two covenants to the Declaration only entered into force in 1976.

8 Whereas the conditions attached to loans to low-income countries have been renamed and reframed often as 'partnerships', the abandoned terminology of conditionality has resurfaced in Europe with the Euro crisis. Loans are granted on the condition that the borrowing nation fulfills a set of conditions listed by the EU commission, the IMF and the ECB.

by way of first taking a look at the circumstances under which the contemporary system has developed. Three processes of policy practice have played in.

First, the initial policy response to problem debt in the Euro zone was similar to the series of crises that started in 1982 with the default of Mexico. In both cases, the crises were initially met as a problem of liquidity rather than insolvency. New loans were granted to pay back old loans. The Latin American crisis was in its fifth year, when Krugman (1988) introduced debt forgiveness and suggested that forgiving should be applied alongside financing. The debt crisis was now considered a crisis of insolvency rather than illiquidity. Soon after, Sachs (1989) took a step further by suggesting that debt reduction could create favourable economic incentives in an indebted country. In a way, dealing with debt has remained in this phase. Under the guidance and supervision of the IMF, *ad hoc* rescue packages are followed by *ad hoc* debt reductions.

Further, by the early 2000s, debt sustainability came to replace the concept of country risk (Cornford 2009). Whereas country risk focused on the risk of a borrowing nation defaulting on its loans, debt sustainability is a more vague concept. Importantly, by way of various debt relief initiatives conditional on debt sustainability, problem debt is now an entrance point for the creditor into the political decision making of the indebted economy. Debt sustainability – or the sustainability gap – became an official tool adhering to a larger context, as part of the toolbox promoting global governance. It became a matter addressed by development aid departments and ministries in donor countries. Without universal rules, problem debt and development aid remain labelled as charity, and not part of a rights-based system.

Finally, what unites the situations of problem debt in Latin America, Africa and now in Europe, is that they have emerged as a result of the global financial order with its institutional frame dating back to 1944. This is because the principles drive each country to increase its exports at the expense of its neighbours, or competitors. But as noted, this is a zero-sum game. Consequently, we must introduce a wider perspective than that of a mere national budget-gap angle aiming at maintaining peace in the financial markets. From this perspective, today's approach to problem debt is problematic for two particular reasons. First, the export compositions of nations differ and this brings with it the fact that, along with trends in global manufacturing, certain nations will always be favoured over others. Over time, the list of globally preferred goods is dynamic. Second, according to Keynes' thinking, nations that successfully accumulate export surpluses simultaneously affect demand elsewhere in a negative way. A recent example is of course the German trade surplus, which has contributed importantly to the Euro crisis.

In addition to the incremental institutionalization that these three processes of dealing with sovereign debt have led to, the general development of the thinking concerning debt must be brought forward. Debt constitutes of course an essential component of economics, be that in the economy of an individual or a household, a corporation, or of a sovereign nation-state. Acquiring debt is a way of securing

funding for investments in order to generate future profit. Following this, the natural assumption is that those who run up debt are responsible for repaying it (*pacta sunt servanda*). Yet, in the case of default, the idea of modern insolvency legislation and debt-restructuring proceedings no longer rests on the liquidation or elimination of insolvent entities. Instead, the aim is to remodel the financial structure of debtors who are experiencing financial distress in order to facilitate their rehabilitation and the continuation of their business. In market-based economies, the debtors' rights are protected. From a moral vantage point, the indebted is provided with new incentives instead of being condemned to prison. From the economists' angle, such a remodelling allows for the indebted to generate profits in the future. This profit benefits society as a whole through increased consumption and taxes and by potentially, or at least ideally, creating new workplaces. With regards to sovereign debt however, the system is more complicated. Legally, the government of a state enters loan agreements on behalf of its population. In the event of a default, the insolvent state cannot be liquidated, and the resources are not necessarily easily seized. Rather, the central legal tension is between the rights of the creditor to be repaid and the human rights of the indebted population. Without an international commonly negotiated framework, dealing with sovereign debt operates in a legal vacuum. What is equally disconcerting is that international debt forgiveness, or relief, is arbitrary as there is no automatic right to it, nor are there any universal rules: it is granted to some countries, but not others, for some types of debt, but not others (Raffer 2007, 247).

A framework for sovereign insolvency proceedings is coherent with reasons for economic efficiency in terms of economic reasoning (Raffer 1990). That discussion is now taken further by shifting the focus to the responsibilities of the lenders. The present approach assesses a debtor country's ability to service its financial obligations, but it says little about the consequences for human development (see Northover 2010).⁹ For instance, what level of debt is sustainable for countries where the vast majority of the population lives under a dollar a day (in low-income countries) or when the unemployment rate approaches 30 per cent (as in Spain in connection to the Euro crisis)?¹⁰ Civil society expresses reservations regarding the concept of debt sustainability. Eurodad (no date) states that the concept is flawed both on theoretical and practical grounds, and on a results-oriented level and instead, advocates a concept taking into account the *resources* the indebted

9 Stephen Mandel treats the terms 'debt sustainability' and 'debt repayability' as synonyms, since they rely "solely on the capacity of a country to service its debts in terms of export earnings and (to a lesser extent) government revenue without regard to the demands on these resources" (2006, 5).

10 The debt overhang of the African continent, for instance, poses major obstacles to the region's prospects for the necessary increased savings and investments, economic growth and poverty alleviation (UNCTAD 2004, 9). In parallel to the Euro crisis, in the East, Japan's debt approached 240 per cent of the size of its economy in 2012, and in the West, the US gross debt, by contrast, is a little over 100 per cent of its gross GDP (Sahadi 2012). Importantly, the IMF (2010), predicts that many of the rich countries' debts are expected to reach 100 per cent of their GDP by 2014. At the same time, social unrest is deepening. Prognoses of decreasing economic growth add to the concerns.

countries need to promote the eradication of poverty. Along similar lines, and picking up on the initial proposal by Raffer (1990; Raffer & Singer 2004, 109, 189, 194),¹¹ the New Economics Foundation supports the replacement of debt sustainability with a human rights approach, which protects a minimal standard of living for the people (Mandel 2006, 12).¹² In addition to factoring political support into any debt sustainability assessment framework, the assessment must also include the average coupon on the debt, the amount of debt becoming due in the near future, the amount denominated in foreign currency, the country's ability to deliver the political and economic adjustments it needs, and domestic debt (Roubini and Setser 2004, 20). The principles of a fresh start, mentioned above in connection to the HIPC programmes, and equitable treatment should be understood in terms of human development (Herman *et al.* 2010b, 492). This means that debt restructuring should not only aim at facilitating economic recovery but at guaranteeing especially that the burdens of adjustment do not severely and adversely impact the disadvantaged in society (Herman *et al.* 2010b, 492). The NEF refers to the UN charter and the obligation by governments to provide a minimal standard of living for their people, and states that this obligation should come before any financial obligations to creditors. A universal framework would also transform the charity-based system of debt rescue packages into a rights-based framework based on just principles.

Putting aside the discussions on the process of creating a framework for sovereign insolvency, the principles it would stand on and the format it would have, because these could be accommodated to some degree, the basic idea is to create a mechanism, perhaps a panel, for assessing debts claimed to be problem debts. The approach of dealing with debt according to peoples' human rights under such a panel would bring about at least two changes. First, the sustainability of debts would be determined not by the creditors, but by a third party. This would not only meet the call that debt assessments should include experts from elsewhere than international financial institutions, themselves creditors and donors to the indebted nations (Wyplosz 2009). If properly implemented it would provide a position of legal equality for both creditors and debtors, with an independent judge, jury and executioner. Second, debts would have to be treated on a case-by-case basis. Different types of sovereign debt represent different types of vulnerabilities, the level and composition of debt and the interaction between public and private debt have not got the attention they merit (UNCTAD 2009b, 19, 20). Both the *reason* behind the debt build-up must be taken into consideration, as well as the *dynamics* by which the debts change shape – from private to public, for instance – and any attempt at measuring sustainability must include a thorough analysis of the causes

11 Raffer has attempted to refer the measurement of debt indicators, or indicators of debt servicing. He suggests basing the index on the debt overhang, or debt due, rather than on payments made, see Raffer and Singer (2004, 176–7).

12 A human rights approach could be specified in terms of the right to food, the right to education, and the right to health (Cheru 2006, 42).

of indebtedness (UNCTAD 2009b, 22). Such a panel could also respond to claims of debt being odious.

In some cases, doubt will arise over the use of and procedure behind acquiring the borrowed funds in the first place and, consequently, some debt is claimed to be 'odious' and therefore not reimbursable. Odious debt was originally defined as debts that have been incurred by dictatorial regimes for their own benefit (absence of consent), and against the interests of the population of a state (absence of benefit), without its consent and with the full awareness of the creditor (credit awareness) (Sack 1927). Claims of debt being odious come under a different jurisdiction than debt acquired on economic grounds (see Sehm Patomäki 2011). A debt can be odious regardless of the economic state of affairs of the nation in question. An independent panel or mechanism could easily be set up to respond to claims pertaining to both jurisdictions. Dealing with debts in this way would update the global financial order, a novelty stapled to the broader goal of both economic efficiency and justice. It would also bring with it elements of justice, even elements of global justice in the way that creditors and debtors would deal with a third party institution or entity.

Sovereign lending is based on the mere *assumption* that loans will be repaid. This assumption is largely based on the threat of markets punishing nations that repudiate or default on their debt. Yet, this threat has proven to be exaggerated, mostly because markets are forward-looking and concerned with the prospect of future winnings (Stiglitz 2010a, 48). Nations that default on their debt are not excluded from the market for forever, or even for very long. In contrast, their economic outlook is far better after restructuring. To illustrate, five years after the Russian default in 1998, its sovereign debt was upgraded to investment grade (Gorbunov 2010). Following the Argentinean default of 2001, its annual GDP growth rate averaged nearly nine per cent between 2003 and 2007 (Stiglitz 2011a). In Europe, Iceland, the only country that repudiated its debts is the nation that has emerged the fastest from the financial crisis. The question is not *whether* a country can default but *how* this is done and dealt with.¹³ The interest lies in justifying the declaration of default by the indebted nation and, then, how to base this declaration on unsustainable debts.

IV. Conclusion

This article makes a case for lifting debt sustainability away from its present place between external debt and GDP. Its new place should be between problem debt

¹³ In reality, of course, the situation is more complex. The gun-boat diplomacy of the past has now been replaced with a more subtle creditor-dominated diplomacy. Soederberg (2005, 929) points out that what remains unchanged are the underlying relations of power in the international credit system. This does not, however, lessen the fact that sovereign defaults do take place, debts are left unpaid and the economic situation of a country generally takes a turn for the better only following a (sufficient) reorganisation of its debts.

on the one side and human rights on the other, where social and economic rights are respected and a minimal standard of living for the people is protected. This new place should be framed with the criteria for *who* decides when a debt is sustainable, and how this should be acted on. Because of the specific characteristics of sovereign debt, the alarm of default must be set by the debtor, not the creditor(s), and, given this, the decision of a nation to declare its default is always political, not economic. The economics of the matter is that the single creditor, and usually many altogether, is assumed to have a more restricted view into the overall financial and political situation than the indebted nation itself. The politics is that problem debt has developed into a state of affairs whereby creditors have control over the sovereign democratic will of the indebted peoples because, ultimately, a nation possesses immense resources to draw from in the form of taxation, privatization, savings and perhaps diversification of exports. Yet, it is for the national government to judge when the threshold of austerity measures is passed, or when it is politically unsustainable. A debt's sustainability is a highly political assessment that cannot be confined to economic parameters, or costs, alone. When a country faces high unemployment levels and its education and social systems are run down because of lack of funds, it is time for the government to listen to the street protesters and declare its debts unsustainable.

Such a way of dealing with debt suggests that an adequate analysis of problem debt must be done separately for each nation and by each nation itself. The different forms of debt, the history behind how they have been acquired and indicators of the country's resources must be taken into consideration. The complexity of the exercise suggests that one is hard-pressed to find a standard or uniform formula.

The process of assessing debt sustainability is still incomplete. The process should be simple for it to be transparent, yet it should be unique to allow for nation-specific situations to be taken into consideration. This means that it cannot be a routine procedure adhering to a standardised formula.

Finally, as these considerations and conclusions suggest, even the best possible design of debt sustainability – or debt (in)tolerance – is bound to be unable to prevent defaults by nations. The international financial system must be updated with a debt resolution mechanism. The putting in place of such a mechanism would provide nations with the opportunity to deal with their debts in an orderly way. Meanwhile, debt sustainability must be carefully thought through. This is because without a clear concept of debt sustainability, such a mechanism is partial, at best.

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